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## Post-crisis regulatory reform in banking: Address insolvency risk, not illiquidity!

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### ABSTRACT

An extensive review of the evidence related to the 2007–09 crisis reveals that it was an insolvency risk crisis, not a liquidity crisis. The appropriate post-crisis regulatory reform should therefore focus on increasing capital requirements. The Basel III liquidity requirements do not serve a useful economic purpose in dealing with the root causes of the stresses that led to the 2007–09 crisis, and unnecessarily constrain the asset transformation and liquidity creation roles of banks to the detriment of economic growth.

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### 1. Introduction

There has been much discussion in recent years about the appropriate regulatory responses to the crisis of 2007–09 that would remove the structural defects most responsible for the crisis. While the entire spectrum of post-crisis regulation in Europe and the U.S. has been vast in scope,<sup>1</sup> there are two pillars of the prudential regulation component of the regulation that are noteworthy: liquidity and capital requirements. In the case of liquidity requirements, there are two liquidity ratios banks must maintain: (i) the liquidity coverage ratio (LCR), which stipulates that a bank's high-quality liquid assets (HQLA) must be at least as much as its total expected net liquidity outflows over 30 days, and (ii) the net stable funding ratio (NSFR), which requires that the available amount of stable funding must exceed the required amount of stable funding over a one-year period of extended stress. In the case of capital requirements, there are also two key ratios: (i) a risk-weighted capital ratio that requires common equity and tier-one capital to be at least 6% of risk-weighted assets, and (ii) a leverage ratio that requires the bank's tier-1 capital to be at least 3% of its average total consolidated assets (including off-balance sheet items).

Why have regulators focused on both liquidity and capital requirements, especially in light of the fact that reserve require-

ments for U.S. banks—the original liquidity requirement—had fallen out of favor as a risk-management tool and was secularly declining prior to the crisis? I believe the reason is the popular view that this crisis had two key features: ex ante misaligned incentives on the part of banks, and an ex post liquidity shock that caused liquidity to suddenly evaporate from the financial system, thereby exposing otherwise-healthy institutions to the risk of failure unless central banks opened up their liquidity spigots.<sup>2</sup> Capital requirements are thought to be appropriate in dealing with ex ante misaligned incentives,<sup>3</sup> whereas liquidity requirements are meant to deal with banks having sufficient liquidity on hand to deal with the next system-wide liquidity evaporation.

This brings me to the central research question of this essay: is the post-crisis focus on both liquidity and capital requirements optimal, given the twin objectives of economic growth and financial stability? I emphasize these as the two key objectives because, as I have argued elsewhere (see Thakor, 2014), it is trivial to achieve financial stability if one does not care about growth. The essence of contemporary theories of financial intermediation is that banks facilitate economic growth by lowering the cost of finance for borrowing firms (e.g. Boot and Thakor, 2000; Ramakrishnan and Thakor, 1984; Coval and Thakor, 2005).

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<sup>1</sup> For an extensive description and analysis of the new regulatory structure, see Greenbaum et al. (2015).

<sup>2</sup> See, for example, the discussion in Thakor (2015).

<sup>3</sup> See Thakor (2014).

My conclusion, based on an extensive review of the existing literature,<sup>4</sup> is twofold. First, the purported tradeoff between financial stability and economic growth is overblown—it is possible to achieve financial stability as well as long-run economic growth. Second, the current emphasis on liquidity requirements is misplaced and stems from the erroneous belief that the 2007–09 financial crisis was a liquidity crisis. Rather, it was an insolvency risk crisis that caused liquidity to flee the system. Hence, the focus ought to be on strengthening capital requirements. Specifically, I recommend six ex ante measures and two ex post measures to achieve greater financial stability and enhanced economic growth.

*Ex Ante Measures:*

- (1) Increase capital requirements for depository institutions and shadow banks, and make them countercyclical.
- (2) Eliminate liquidity requirements.
- (3) Restrict consumer leverage and improve consumer literacy.
- (4) Create a better business model by creating a bankruptcy code (Chapter 11) for banks.
- (5) Design a more integrated regulatory structure.
- (6) Focus on bank governance and culture.

*Ex Post Measures:*

- (1) Resolve financial crises through (temporary) government capital support that dilutes current shareholders and by imposing dividend restrictions.
- (2) Have greater consequences for the executives of failing banks.

The rest of this essay is organized as follows. Section 2 discusses the first two ex ante recommendations, along with the empirical evidence underneath those recommendations. Section 3 discusses the third recommendation. Section 4 discusses recommendations four through six. Section 5 discusses ex post measures. Section 6 concludes.

## 2. Increase capital requirements and drop liquidity requirements

My discussion in this section is in three parts. In the first part, I briefly review the empirical evidence, which strongly indicates that this was an insolvency risk crisis, not a liquidity crisis. In the second part, I discuss the implications of increasing capital requirements, in the third part, I discuss the implications of eliminating liquidity requirements.

### 2.1. Was this an insolvency or illiquidity crisis?

An insolvency crisis is essentially a “counterparty risk” crisis. Investors refuse to extend financing to institutions because they view the credit risk of the institution as being excessive, given their asset portfolios and capital structures. A liquidity crisis is one in which, for some reason, liquidity evaporates, so that institutions reliant on short-term debt experience funding declines and may be compelled to engage in asset fire sales to raise funding. Typically, the liquidity evaporation is linked to a coordination failure of some sort.

An important difference between the two types of crises is that an insolvency risk crisis is bank specific in that it affects only banks that are viewed by investors as being excessively leveraged and/or excessively risky. By contrast, a liquidity crisis indiscriminately affects all banks, regardless of fundamental financial health.

<sup>4</sup> For the relevant literature reviews, see Thakor (2014), Thakor (2015), and Greenbaum et al. (2015).

While the proponents of the view that this was a liquidity crisis acknowledge that there were insolvency-risk forces at work, they reason that the direction of causality was from illiquidity to insolvency. That is, the sequence of events was that liquidity first shrank in the system, which forced substantial reductions in demand for assets and also fire sales, which drove down asset prices, which then—due to assets being marked to market—reduced equity in institutions and elevated insolvency risk. So their view is that liquidity risk and insolvency risk are endogenously co-determined, and a policy recommendation emerging from this is that central banks must flood the market with liquidity, so that the spillover effect of liquidity risk on insolvency risk can be avoided.

The proponents of the insolvency risk viewpoint propose that asset prices decline due to a shock to fundamentals, and this causes the equity values of highly-leveraged institutions to fall, which then diminishes their short-term borrowing capacity. Liquidity dries up because investors are unwilling to finance institutions that have debt overhang problems or are insolvent.

Empirically distinguishing between these two viewpoints is important for two reasons: assessing appropriate policy interventions during the crisis, and determining the appropriate post-crisis regulation design.

The empirical evidence strongly indicates that this was an insolvency risk crisis, not a liquidity crisis. There are four strands of research that provide this evidence.

First, as I indicated earlier, if this was a liquidity crisis, it should have caused funding access to dry up for all institutions. The empirical evidence for the U.S., however, is that the majority of commercial and investment banks did not experience diminished funding during the crisis and did not engage in the fire sales predicted to accompany liquidity crises.<sup>5</sup> This evidence also indicates that the institutions that did experience liquidity shortages during the crisis were those whose insolvency risk had risen due to a deterioration in asset values. In addition, using transaction-level data on short-term, unsecured certificates of deposit in the European market, Perignon, Thesmar and Vuillemy (forthcoming) document that there was no market-wide funding freeze for banks during 2008–14. During this time, banks with higher capital, higher profitability and fewer impaired loans actually increased their short-term (uninsured) funding, whereas the more highly-leveraged banks with lower-quality assets reduced their access to this funding. There was thus a reallocation of liquidity based on differences in insolvency risk. The authors point out that their evidence is inconsistent with any coordination-failure theory of bank runs, i.e., they rule out a liquidity crisis story.

Second, there is also empirical evidence that the massive withdrawals from money market mutual funds (MMFs) during 2008 were not precipitated by a market-wide liquidity crunch that just caused a run on those funds. Rather, as Kaepczyk and Schnabl (2013) document, these withdrawals were due to asset risk and insolvency concerns. The disclosure that the Reserve Primary Fund had suffered significant losses due to its holding of Lehman Brothers commercial paper laid to rest the commonly-held belief that MMFs invested only in safe assets.

Third, in direct contradiction to the liquidity crisis hypothesis, there is substantial evidence that banks with higher capital ratios were less adversely affected by the crisis. Specifically, banks with higher capital ratios:

- were more likely to survive the crisis and gained market share during the crisis<sup>6</sup>;

<sup>5</sup> See Boyson et al. (2014).

<sup>6</sup> See Berger and Bouwman (2013).

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